FACING UP TO THE RISK CHALLENGE

WHAT DO THE GLOBAL PLAYERS REALLY THINK ABOUT TAKING AN INTEGRATED APPROACH TO RISK MANAGEMENT? **JOHN HAWKINS** OF EMAP SCOURS THE MARKETS TO GET SOME ANSWERS.

The debate on the merits and practicality of an integrated approach to risk management rolls on. Few treasurers share an identical view and the perspectives of other participants in international risk markets can be even more disparate. Some of these perspectives were recently explored in a survey involving participants from leading accounting firms, banks, corporates, insurance brokers and underwriters. The questions sought to understand the respondents' views on the general concept of integrated risk management, the relevance of the Turnbull Guidelines and the development of integrated risk management products. Although many differences of opinion came to light, it was possible to detect several common threads, some of which may be considered surprising. There follows a summary of what the respondents had to say[1].

EDUCATION. Risk is usually poorly taught at whatever level of the education system one chooses to examine: classes at primary and secondary school, undergraduate and postgraduate lectures at university and courses for professional examinations. Unlike return, of which most people have an innate understanding, the concept of risk is largely foreign and this has not been addressed by the development of appropriate teaching methods[2]. This situation is unlikely to change in the short term.

RISK MANAGEMENT AND CORPORATE FINANCE. The absence of insurance from the standard models of corporate finance has held back a co-ordinated approach to risk management and finance in the corporate environment. That work which has been carried out in this area, for example by Prakash Shimpi[3] and at Wharton Business School is not well known and deserves to be used more widely. In an increasingly cost-competitive market, where the true value of every dollar spent on insurance and other risk management products may be difficult to assess, this is the one area, above all others, that would benefit from further theoretical and empirical research.

THE VOCABULARY OF RISK MANAGEMENT. That words and phrases have different meanings in different places is not at all

SUGGESTED TERMINOLOGY...

☐ FINANCIAL RISKS. Those risks, usually arising through economic causes, that can be nullified by entering into a derivatives contract designed to produce an equal, but opposite, result (ie hedged). To the extent that the correlation between the risk and the derivative is imperfect, the loss may not be fully indemnified. These are also known as speculative, or dynamic, or 'two-way' risks, since they can result in gains or losses. Although some derivatives involve the payment of a premium (eg currency options and interest rate caps), others do not (eg forward foreign exchange contracts and interest rate swaps).

☐ INSURABLE RISKS. Those risks, usually arising through natural causes or human accident or error, that can be transferred to third parties through the use of traditional insurance contracts (ie insured). The loss will be fully indemnified, within agreed coverage limits, in the event of a bona fide claim. These are also known as pure, or static, or 'one-way' risks, since they can only result in losses. Conventional insurance policies always involve the payment of a premium.

☐ INTEGRATED RISK MANAGEMENT. The management of financial and/or insurable risks on an integrated basis, ie taking into account their degree of interdependence. Unlike Enterprise risk management (see below), it is about specific techniques and tools used for this purpose.

☐ OPERATIONAL RISKS. Those risks that cannot be hedged or insured. They are also generally speculative, in the sense that like financial risks they can result in gains or losses. It is to be expected that over time the relative number of such risks will reduce as additional derivatives and insurance products are developed, a recent example being patent risks.

☐ ENTERPRISE RISKS. The sum of the financial, insurable and operational risks facing an enterprise.

☐ ENTERPRISE RISK MANAGEMENT. The management of all the risks facing an enterprise on a comprehensive and holistic basis, taking into account their inter-relationships and the resources available for their management. It is therefore an approach to, or a philosophy for, risk management, rather than a particular technique or series of techniques. In its very widest sense it may also include the allocation of capital within a corporation and the use of tools designed to facilitate risk management.

: unusual; neither is it that different people have different words for the same thing. Even in one place among one group of people language evolves. We should probably not be too hard, therefore, on an internationally dispersed profession that has experienced some difficulty in defining its scope and even greater difficulty in promulgating consistent meanings for integrated risk management and enterprise risk management. However, until such time as more discipline is exercised and the use of jargon reduced, practitioners should not be surprised if they are often not clearly understood. Moreover, the most effective types of communication generally work in two directions and practitioners must also ensure they have the educational and language skills to understand those with whom they are communicating, who will often have a much broader range of responsibilities than risk management alone. Communications are also rendered less effective by barriers, the erection of which has been something of a speciality of the insurance industry over the years.

THE STATUS OF RISK MANAGEMENT. In days when leading institutions count *feng shui* experts on their payroll, it should not be surprising that risk management practitioners should consider themselves as a member of a 'profession' – and at that, one more broadly defined than simple insurance. Risk management has been around for almost half a century, a period not much different, for example, from marketing and operations research, both of which would generally be regarded as having earned their niches in the pantheon of the professions. Risk management has its gurus, but none as yet have made it to the first rank of management theorists or written the definitive textbook. Meanwhile, many risk management practitioners need to improve their self-view if they wish for society to hold them in more esteem than they sometimes hold themselves.

THE PLACE FOR RISK MANAGEMENT. The structure and culture of organisations is sufficiently diverse that there can be no absolutely correct way to organise and manage the risk management function. However, it seems inevitable that board level responsibility for risk in most corporates will be increasingly within the finance function. Nobody expects the CFO or financial director to be a master of all trades, but just as it is now strange to imagine an accounting qualification not involving at least the key aspects of corporate treasury, it will in future be considered equally absurd to note the absence of at least the key elements of risk management. The sooner this lacuna is dealt with, the higher the probability that the accounting profession can maintain the fortuitous lead in this area it has achieved as a result of its intimate involvement with Turnbull. Of course, whether or not this is desirable is another issue.

THE TURNBULL GUIDELINES. The authors of the Turnbull Guidelines would probably be satisfied if the consensus opinion of their work was that it could be described as a 'flawed masterpiece'. In reality, only one of these words was encountered and, regrettably, it was not 'masterpiece'. Turnbull was conceived as a set of guidelines on internal controls. During its gestation it transmuted into a potpourri, including a prayer for a new philosophy of risk management. It cannot be surprising that it has been poorly received so far and it will not be surprising in future if it is relatively quickly supplanted by something more focused and relevant, produced by a body with a more balanced view than the ICAEW. The question of Turnbull's 'lack of teeth' was raised, but a similar criticism has been levied at the Combined Code in general and the consensus seems to be that it is too soon to determine whether stricter sanctions need to be contemplated seriously. Internationally, there seems to be a case for aligning corporate governance regulations, as is already the case with accounting standards.

RISK MANAGEMENT AND ACCOUNTING STANDARDS. There is little doubt that in the US the introduction of FASB 133, requiring the marking to market of all derivatives products (defined very broadly) has acted as a brake on the development and utilisation of products that seek to integrate the management of insurable and financial risks. While full disclosure of derivative positions is generally considered to be beneficial to both large and small investors, the income statement impact of marking to market is not. The increase in the volatility of earnings resulting from the implementation of this accounting standard has caused a groundswell of antagonism towards FASB by financial institutions. The chances are that at some time over the next five years the application of the marking to market rule will be relaxed[4].

THE FUTURE OF ENTERPRISE RISK MANAGEMENT. Notwithstanding the considerable shortcomings of Turnbull, the intellectual and regulatory cases for corporate risk management are individually persuasive and together compelling. As with the early mobile phones that were regarded as trendy, unnecessary and expensive, there is still a body of thought that believes enterprise risk management will not become a permanent addition to the executive's repertoire of valid approaches to strategic management. This is almost certainly a mistake. The present corporate risk management edifice may shrink in size, like the mobile phone, but it is unlikely to be ephemeral.

INTEGRATED RISK MANAGEMENT PRODUCTS: SOLUTIONS LOOKING FOR PROBLEMS. There have been many cases where technology has been developed and then had to await the arrival of a suitable opportunity for its application. Some would argue that this is the case with many integrated risk management products today. In practice, however, the technology may be less perfect than some of its proponents would prefer to admit (or inadequately mastered by them), and those areas where it has been applied successfully have tended to involve incremental advances rather than 'quantum leaps'. Risk solutions that push forward the limits of insurability seem to be market driven and therefore successful. Those that integrate for integration's sake often have a precarious existence.

DEMAND FOR INTEGRATED RISK MANAGEMENT PRODUCTS. One of the determinants for the relatively slow take-up of multi-year, multi-line insurance programmes is the prolonged 'soft market' that has held sway since their theoretical attractions began to be better appreciated. However, there has been almost no discussion of the fundamental difference between the relative methods of premium pricing for insurance products and financial derivatives. Whereas various sophisticated models provide a high degree of objectivity in the pricing of derivatives, this is not the case for insurance products. For example, it has been suggested that macro-economic factors, such as interest rates and stock-market levels have a strong but not easily quantifiable, impact on premium levels as well as loss experience. One result of this is that the phenomenon of cyclicality, frequently observed in a variety of insurance markets, is unknown in derivative markets. The corollary is that even if a

prolonged 'hard market' has a positive impact on the use of integrated insurance products, it is unlikely to have a dramatic impact on the use of combined insurance/financial risk products.

LEADING INSURANCE PROVIDERS: BEHIND THE BANKS OR THE EIGHT BALL? Probably the commonest criticism encountered of purveyors of integrated risk management products, whether brokers or insurers, has been their failure to communicate adequately the benefits of their wares.

A number of factors seem to be involved, not least the separate and rapid evolutions of the insurance sector and the corporate risk management function. However, the evolution of the banking sector has been at least as rapid over the past decade and a similar criticism has not often been heard in respect of 'sophisticated' banking products. It seems possible that the early adoption by the banking sector of well-trained account executives in a position to understand effectively all of the needs of the finance directors and treasurers may have made the difference. Typically, this has not been the pattern adopted in the insurance sector, where product specialists have often not been in a good position to grasp the overall needs of the client and to see opportunities for growth and innovation.

While some firms have made progress in this area, much remains to be done in terms of restructuring the insurance/corporate interface, particularly in terms of training in general financial skills (including corporate finance) and basic communications. If the insurance providers do not follow this path, they risk the capital markets partners with whom they are increasingly working on some types of deal usurping the lead role that many would believe to be rightfully theirs.

Another relevant factor is that where mergers have occurred between leading banks and commercial lines insurers, real cultural differences seem to have impeded the generation of the synergies that might have been expected in the area of integrated risk management.

CONVERGENCE: WINNERS AND LOSERS. It is not clear who will emerge at top of the integrated risk management tree. Consolidation in the insurance sector has not only resulted in fewer firms, but also the subsequent withdrawal of some of the merged firms from global risk management. The 'super-group' bancassurance mergers (for example, Citicorp/Travelers, Credit Suisse/Winterthur and Allianz/Dresdner KW) do not seem to have been orchestrated with these particular synergies in mind. However, the resource being devoted to this area by some of the big reinsurance industry players is considerable and reflects the relatively favourable character of the reinsurance (as opposed to direct insurance) market, but they are not generally considered to be expert in capital markets products. For now at least, the buy-side of the capital markets seems myopically focused on bonds to the detriment of more effective and therefore, ultimately, more rewarding risk transfer products (for example, contingent capital). The sell-side of the capital markets has the capacity to succeed if it wishes to do so but presently does not seem to be deploying its resources to their full extent. However, the status quo will not be preserved and the big money has to be on the investment banks, mainly because they have the capacity to pay the highest salaries and attract the best staff should they wish to do so. This may be on the basis of informal, or even formal, alliances with insurers, but it is not beyond the bounds of possibility that, for example, a Swiss Re may end up owning a Merrill Lynch.

'THERE IS STILL A BODY OF THOUGHT THAT BELIEVES ENTERPRISE RISK MANAGEMENT WILL NOT BECOME A PERMANENT ADDITION TO THE EXECUTIVE'S REPERTOIRE. THIS IS ALMOST CERTAINLY A MISTAKE'

WEIGHING UP THE RISKS. Drawing a conclusion from the issues raised and ideas volunteered is not easy. In one way or another, corporates are having to think more about the risks faced by their businesses, creating a demand for products and services that facilitate this. Meanwhile, the search for value continues, which should also ultimately help to provide a receptive audience to providers of integrated risk management products.

The steady convergence of the capital and insurance markets and the partnerships thereby developing should ensure that at least some product providers have the intellectual and communications skills necessary to take advantage of increasingly favourable circumstances.

Product buyers are simultaneously finding themselves in a position where they have to take a broader view and acquire the additional skills needed to perform well in expanding roles. *Thinking* about risk management is changing quickly and dramatically. Dramatic changes in risk management *practices* will take place at a slower pace and may never achieve the levels imagined by some, but they will occur.

John Hawkins is Acting Group Treasurer of EMAP plc and a member of the Association's Examination Board.
john.hawkins@plc.emap.com
johnwh@rakshasa.demon.co.uk

[1]A longer version of this article *The enterprise, risk and integration* appeared in the Journal of Insurance Research and Practice, Volume 16, Part 2, pp 5-17, July 2001. Further details of the questionnaire and the participants may be found in the original dissertation from which both have been drawn, *Integrated Risk Management*, Hawkins, John W, 2000, which may be referred to in the Cyril Kleinwort Library of the City University Business School.

[2]See, for example, *Take a chance* New Scientist, 12th August 2000.

[3]Shimpi, Prakash A. ed. (1999). Integrating corporate risk management. Swiss Reinsurance Company, Zurich, 1999.

[4]The precedent for this is the introduction of FASB 22, which modified FASB 8, the original standard on accounting for foreign exchange hedges.